REA Members Discussion

Renewables Obligation Call for Evidence
Introducing Fixed Price Certificates

REA Competition Law Policy

- REA's compliance with all aspects of UK Competition Law applies to all activities of REA including its subsidiaries Member Forums, committees, working groups, technical groups, and sub-groups and any other such meeting:
  - Members are not permitted to discuss competitively sensitive information, or to use REA as a conduit for such discussions
  - Competitively sensitive information covers any non-public strategic information about a business's commercial policy. It includes, but is not limited to, future pricing and output plans
  - Please note this session is being recorded for note taking purposes.

Agenda and Meeting Purpose

- Current RO Arrangements
- Rationale for Fixed Price Certificates
- Considering Model 1 (No trading) and Model 2 (With Trading)
- Reconciliation Mechanism and Other Design Options
- Pricing
- Timing
- Next Steps

Purpose:

- Inform the REAs response to the consultation
- Understand member concerns in advance of industry meeting hosted by DES NZ tomorrow. Tomorrow 13.00 -14.00.

Current RO Arrangements

UK electricity suppliers are obligated to meet a percentage of their supplied energy from renewable sources, by presenting ROCs to the administrator (Ofgem).

Level of obligation set each year by DES NZ, in agreement with Scottish And NI Executive. Typically, 10% higher than expected forecast of ROCs (the headroom).

Accredited Generators receive ROCs from Ofgem. No. of ROCs dependent on type of low carbon generation.

Suppliers buy ROCs from generators, in addition to the electricity generated, often via a Power Purchase Agreement (PPA) or via trader/auction.

ROC value determined by supply and demand.

Instead of presenting ROCs, suppliers can choose to pay the 'buy-out' price, which is expected to be more expensive than a ROC and its value is adjusted each year in line with RPI. (£59.01 per ROC for 2023/4)

The buy-out and late repayment fund is redistributed to suppliers who presented ROCs, providing additional value. This is often recycled to generators through PPA arrangements.

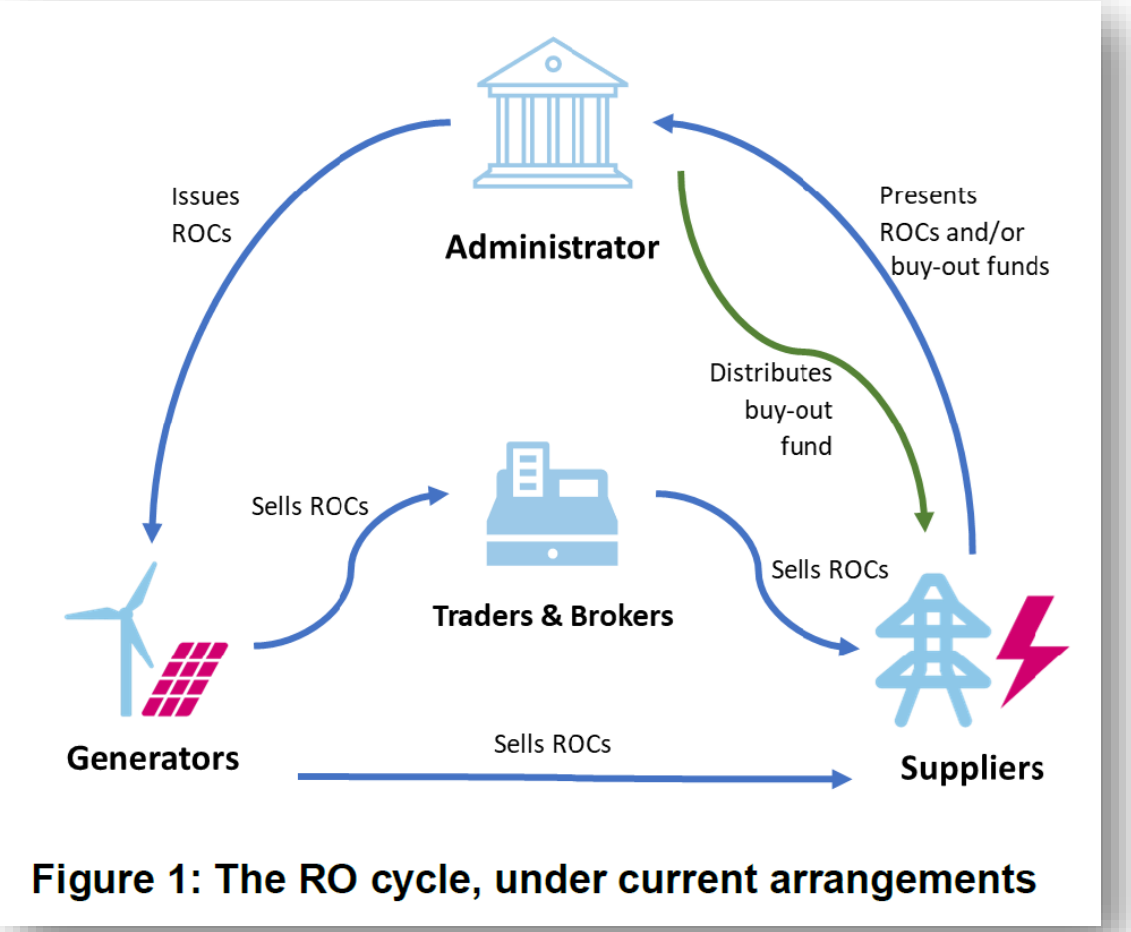


Figure 1: The RO cycle, under current arrangements

Rationale for Fixed Price Certificates

Price Stability: Current generators will start to come to the end of their ROC contracts from 2027 onwards. This could lead to number of ROCS diminishing. Expectation is that more suppliers will choose to pay the buy-out price to meet a smaller obligation. This could create volatile ROC prices. FPC could provide confidence to generators in last years of the scheme.

Reducing supplier default and mutualisation risk: FPCs could see more regular payments from supplier (monthly/quarterly) reducing default risk.

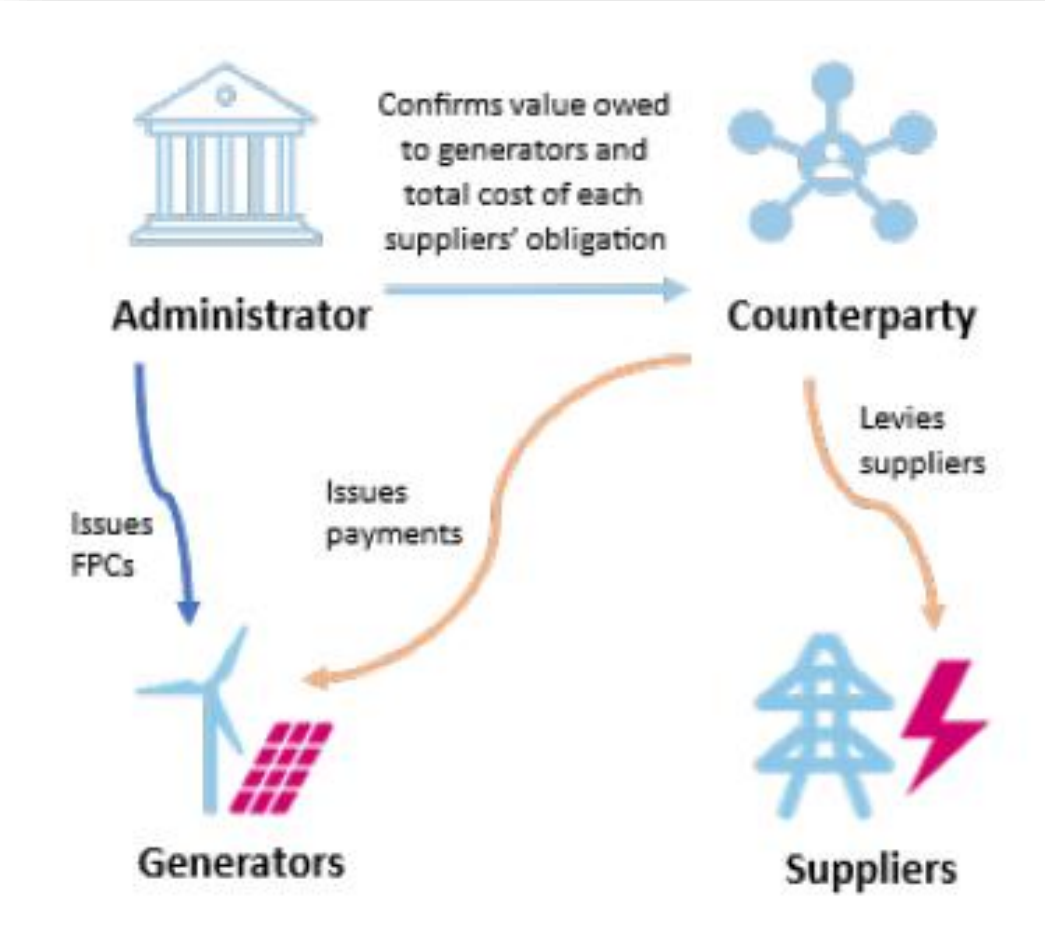
Reduce cost of the scheme: FPCs could be more predictable, requiring less financial headroom delivering cost reductions in the scheme.

Rebalancing gas and electricity costs: easier to reassign the cost of ROCs off the electricty bills if the trading element of ROCs is removed.

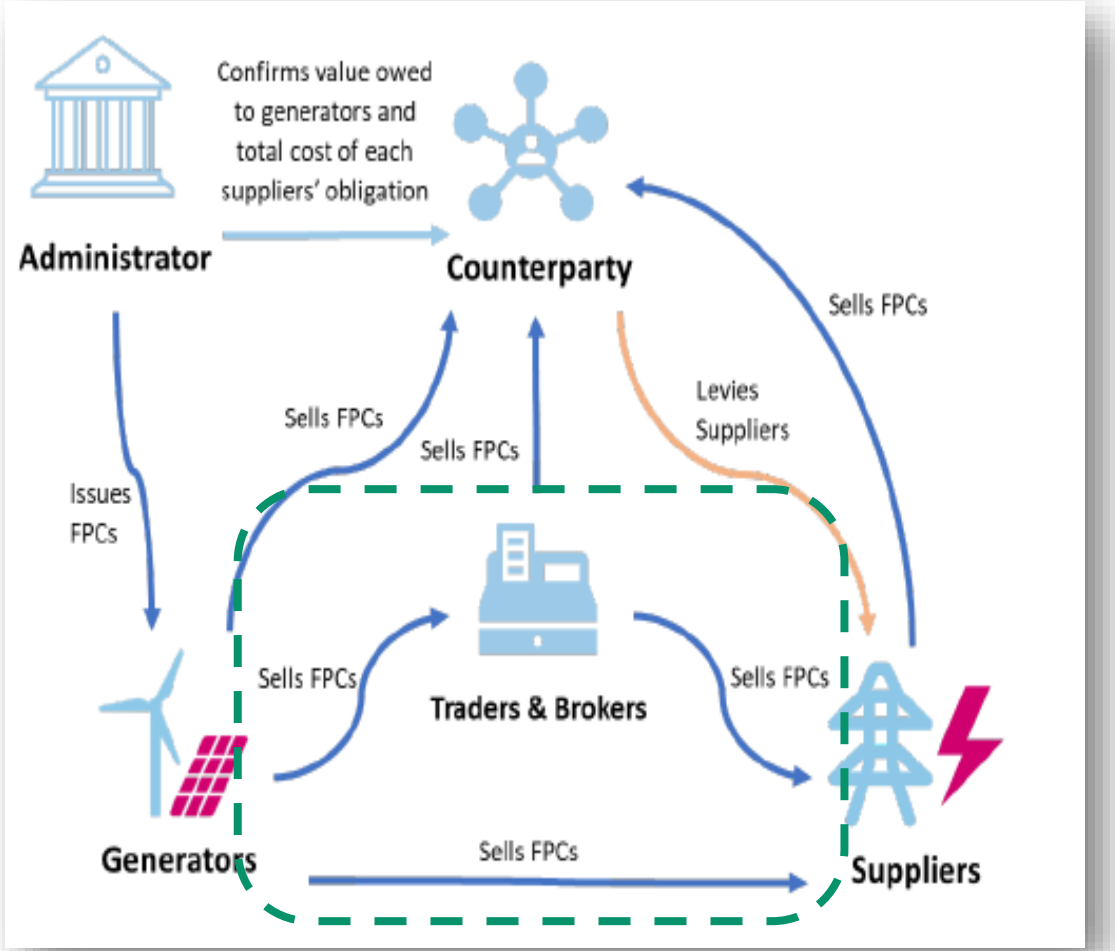
However, noted potential downsides:

- Risk of disruption to scheme
- More regular payments from suppliers could already be achieved by changes already being put in place to reduce likely hood of mutualisation.
- Reduce suppliers working capital/cash flow
- Potential reduction in scheme value to generators (inc. loss of recycle value).

Two proposed Models



Model 1: Counterparty with no trading



Model 2: Counterparty with trading

Model 1 & Options – Central Counterparty, no trading

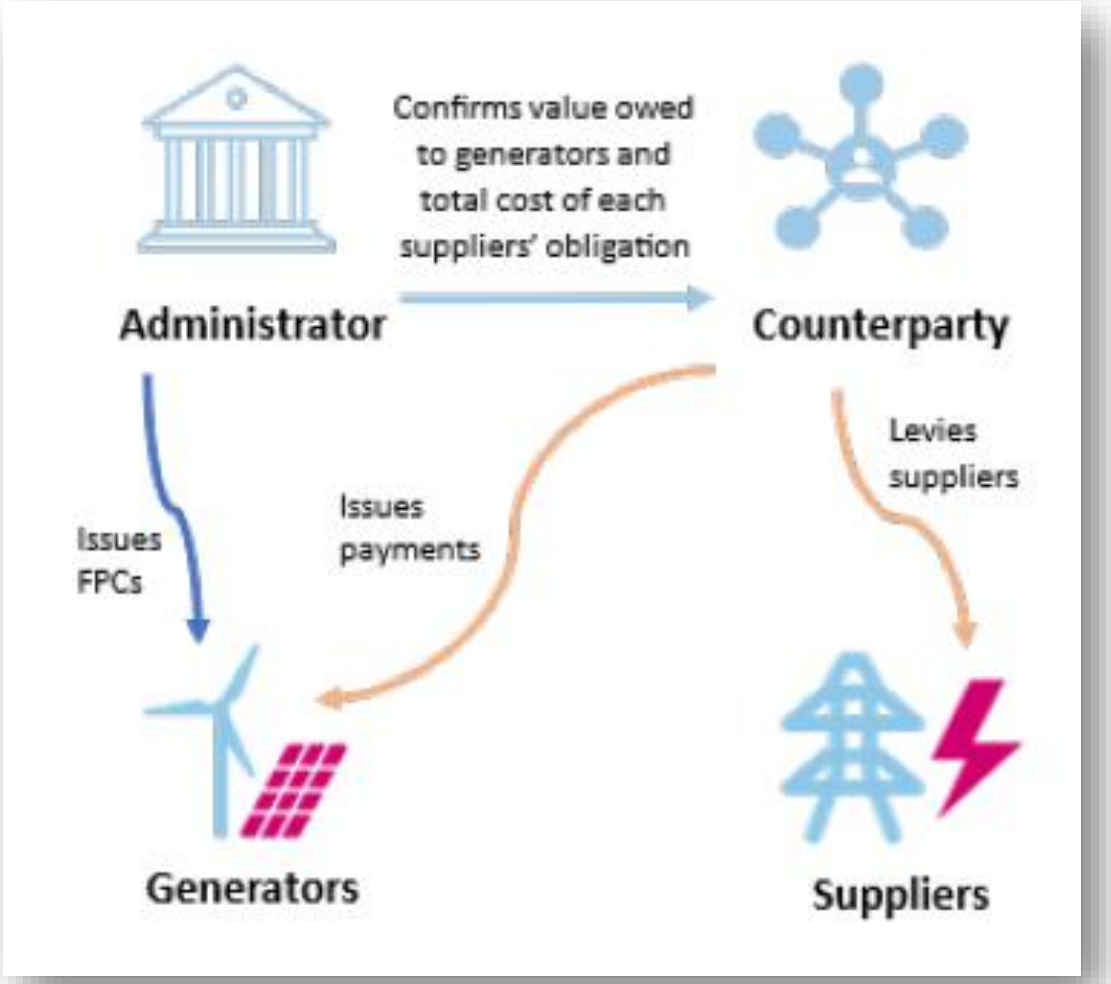
Central counterparty appointed to pay generators for the certificates and setting suppliers obligations by collecting funds owed.

There would be no trading of FPCs, as payment would be given directly by and to the central counterparty.

This would:

- increase revenue certainty for generators
- create long term administrative savings for suppliers
- reduced costs for consumers as third-party traders' fees would be eliminated

However, loss of benefits from the trading of certificates.



Model 1 & Options – Central Counterparty, no trading Frequency and Sequencing of Payments

Government want to balance importance of frequency of payments to generators and impact on suppliers if payment is required more regularly.

Government proposes generators receive monthly payments from central counterparty in all option.

However, there are options of frequency for supplier settlements depending on whether done on retrospective or advanced data and how frequently it is settled.

Table 1: Summary of frequency and sequencing options for supplier settlements

	Retrospective	**Advanced**
Monthly	Option 1	Option 3
Quarterly	Option 2a	Option 4a
Annually	Option 2b	Option 4b

Option 1 would require suppliers to provide retrospective supply data every monthly.

Option 2 sees supplier obligation moved to quarterly or annually, based on retrospective data. Counterparty would require buffer funds as generators paid more regularly than suppliers' obligation.

Option 3: Sees estimated supplier obligations used and then a reconciliation mechanism every month. Ensure prompt payment to generators, but potentially need correcting later.

Option 4: Supplier obligation issued in advance on a monthly or annual basis. Again, ensure prompt payment but possibly require bigger headroom costs.

Questions

Q1. What are the benefits and drawbacks associated with Model 1?

Q2. On balance, which option for frequency of payment and settlements do you think strikes the best balance of benefits for all market participants and why?

Q3. For your preferred option, which measures are most important to minimise the risks associated with this option?

Q4. What would the impact of each option be on scheme administration, including costs?

Q5. What broad impact would Model 1 have over the sector? We welcome evidence specifically on cost of capital, risk premiums, and administrative costs to relevant market participants.

Model 2 – Central counterparty, trading in certificates
Frequency and Sequencing of Payments

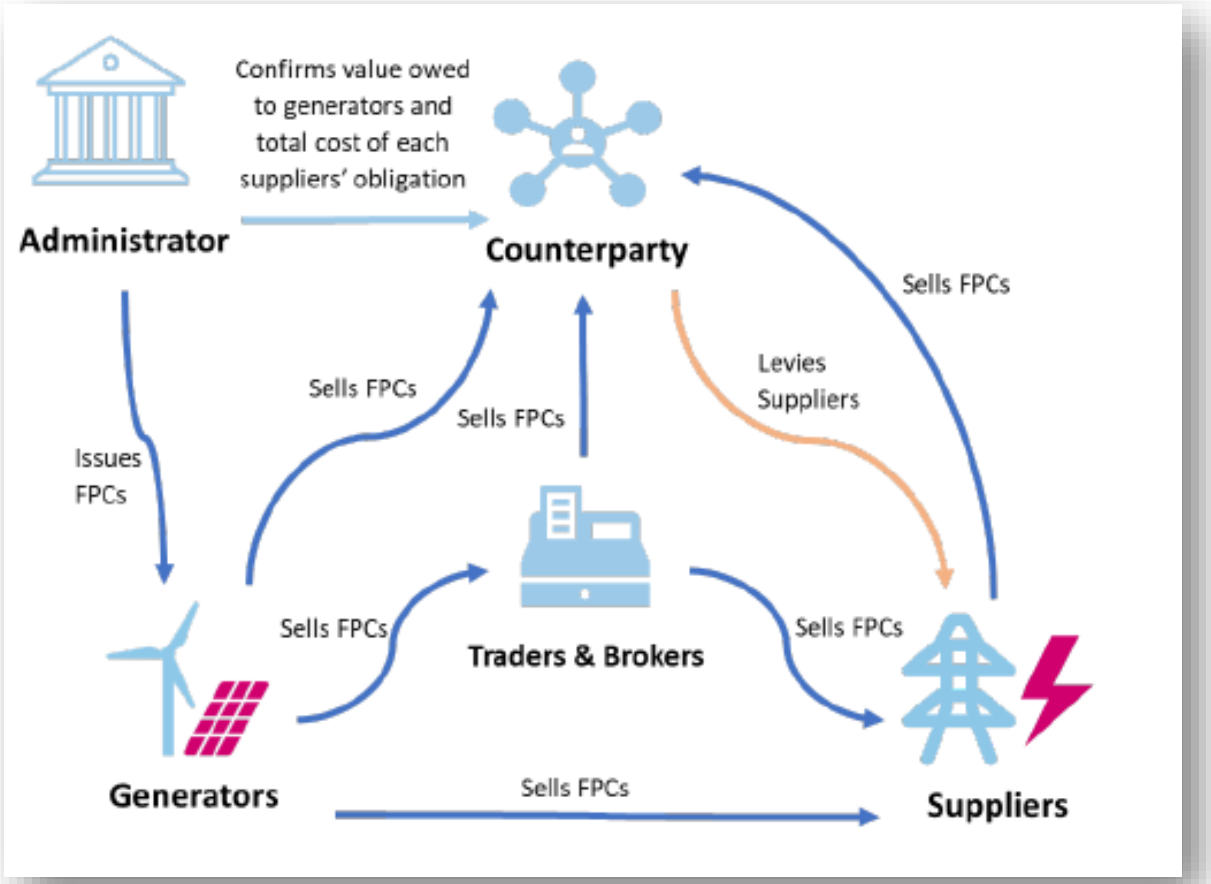
Administrator continues to issue certificates and confirm suppliers' obligation.

Central counterparty would purchase certificates at a fixed price either quarterly or annually.

Central counterparty also levies suppliers for obligation.

Trading of FPCs would still be allowed, which may aid cashflow for generators especially if settlement is annual.

Up to supplier what they do with ROC value sold to counterparty.



Model 2 – Central counterparty, trading in certificates
Frequency and Sequencing of Payments

Central counterparty would purchase either quarterly or annually. Monthly not considered as this would disincentivise trading.

Generators submit data monthly

	Quarterly certificate purchase windows	Yearly certificate purchase windows
Quarterly supplier settlements – Retrospective	Option 5a	Option 5c
Yearly supplier settlements – Retrospective	Option 5b	Option 5d
Quarterly supplier settlements – Advanced	Option 6a	Option 6c
Yearly supplier settlements – Advanced	Option 6b	Option 6d

All Option 5 would require a bridging reserve to be established to cover the first payments to generators during the launch of the new schedule.

Option 5a and 5b settlement by suppliers would be shortly after purchasing window.

5b sees suppliers settle annually after obligated year.

5c settle quarterly for the obligation accumulated in previous year.

All option 6 would require a reconciliation mechanism to bridge any gaps between the supplier payments and the actual funds required

6a and 6d the advanced settlement by suppliers could be due shortly before each purchasing window opening.

6b, could be due shortly before the first purchasing window opening.

6c, supplier settlements could be due every quarter, with the full amount collected before the annual purchasing window opens, effectively dividing advanced payments

Questions

Q6. What are the benefits and drawbacks associated with Model 2?

Q7. On balance, which option for frequency of payments and settlements do you think strikes the best balance of benefits for all market participants, and why?

Q8. For your preferred option, which measures are most important to minimise the risks associated with this option?

Q9. What would the impact of each option be on scheme administration, including costs?

Q10. What broad impact would Model 2 have over the sector? We welcome evidence specifically on cost of capital, risk premiums, and administrative costs to relevant market participants.

Q11. Of the two models presented in this document, which would you favour, and why?

Reconciliation Mechanism

Where advanced data is used to set obligation, a reconciliation mechanism will be needed.

This could be done either via:

Headroom in Supplier Obligation: If funds not required this could be redistributed to suppliers or generators. If redistributed to generators, this would provide a degree of protection against volume risks – shielding generators from low receipts during periods of limited generation. If to suppliers, then this could be reflected in lower consumer bills in subsequent period.

Reserve fund: established through an initial levy on suppliers in the settlement period(s) prior to the launch of the scheme and would be greater than the likely maximum shortfall (based on historic trends) in any one settlement period. When drawn upon, the reserve fund would be replenished by a levy on suppliers in subsequent obligation period. No option for generators to receive benefit of redistributed surplus funds.

Questions

Q12. What are the respective benefits and drawbacks of having advanced payment by suppliers and reconciliation? On balance, do you consider that the benefits outweigh the drawbacks?

Q13. What are the benefits and risks of adding headroom to the supplier obligation to manage any potential discrepancy between the forecasted supplier obligation and actual generator receipts?

Q14. How should the surplus headroom be redistributed, and why?

Q15. What benefits and drawbacks would a reserve fund have as compared to a headroom?

Q16. Besides headroom and a reserve fund, are there other options for dealing with the risk of misalignment under advanced settlement options?

Additional Design Options

Bridging Reserve - under certain retrospective settlement options, the central counterparty will require funds to pay generators or purchase certificates from market participants during the first payment period, prior to suppliers having settled. A one off capital reserve could be established by a levy on suppliers in advance of the scheme.

Q17. What risks might this option present for suppliers, consumers, or the central counterparty?

Transitional Arrangements - Suppliers could be required to make payments under the new schedule in advance of having settled their obligation for the previous year.

Q18. What information regarding the introduction of the new schedule will suppliers require and by when to set consumer tariffs and manage PPA arrangements appropriately?

Central Counterparty and Administrator Roles. These could be done by either the same entity or separate ones. Being done by the one body could deliver efficiencies, but could introduce conflicts of interest.

Q19. What are the potential benefits and drawbacks of centralising both functions of administrator and central counterparty into a same entity?

Pricing

Current price set by market and a factor of supply and demand. Typically set in PPA or via Trading.

Generators with a PPA may also see value in the redistribution of the ROCs Recycle Value made up of buy-out payments and late payment fees.

Price influenced by level of Obligation based on ROC forecast. A 10% currently headroom included to ensure forecast above generation and that ROCs maintain value.

In a FPC model: FPC could deliver price stability so headroom may no longer be required.

"Government could choose a price which equates to the current buy-out price and does not include an uplift to compensate for the lack of redistributed buy-out fund payments"

CPI or RPI : RO currently indexed against the Retail Price Index, which ONS suggest could overstate inflation. It is proposed that the Consumer Prices Index (CPI) may be a more suitable metric for inflating the strike price to reflect changes in the economy. Also note that CPI is already used in the CfD.

Annual Indexation Calculation: In current model inflation is compounded year-on –year, for Government this risks locking in ROC prices which are higher than those which generators would have anticipated . FPC calculation could change. Two options:

Option 1: Base Price + previous year inflation
Option 2: Base Price, adjusted to reflect previous years electricity prices.

Questions

Q20. What factors should be taken into account when setting the price of FPCs?

Q21. Should the price of FPCs be set at a level which excludes the ten per cent headroom built into the current scheme? Why and why not? As caveated above, please treat these questions as only applying to scenarios where the chosen FPC model does not involve the use of a new headroom designed to manage misalignment between the supplier obligation settlements levied and the payments issuing to generators.

Q22. Should the price of FPCs be indexed to the CPI instead of the RPI (as under the current scheme)?

Q23. What would be the implications for generators of a shift to CPI? How much of an impact would this have on the viability of continuous operation of RO plants?

Q24. What are the benefits and drawbacks associated with Option 1 and Option 2 of this section? Which option would you favour?

Timing

In 2011 intention was to transition to FPC by 2027.

However, due to large number of projects joining scheme just before closure to new applicants between 2015 – 2017, price volatility now expected to have biggest impact in 2030s.

However, Government still thinks there is benefit to transition by 2027 given potential to provide certainty, lower cost of the scheme and helping rebalance electricity and gas bills.

Q25. Do you agree with the proposal to introduce the new FPC model in 2027?

Q26. What length of time would constitute a reasonable period of notice for market participants and other parties (e.g. administrator, counterparty) to prepare for the transition to the new model?

Next Steps

Industry DES NZ Call Tomorrow 13.00 -14.00. Join HERE.

REA will be developing their response. Draft response will be circulated second week of September.

Deadline 9th October.

Thank You

@reassociation

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